

## Chapter 4

### SUMMARY OF TREASURY DEPARTMENT PROPOSALS AND THEIR EFFECTS

#### I. The Proposals in Brief

This chapter summarizes the Treasury Department proposals for reform and simplification of the income tax and their effects on revenues and the distribution of tax burdens. Chapter 5 provides a detailed discussion of proposals that would affect most individual taxpayers. For the most part, it deals with taxation of income from labor and self-employment. Details of proposals for reform of the taxation of corporations and of income from business and capital are presented and discussed in chapters 6 and 7. The Treasury Department proposals that affect these features of the tax law are of little direct significance for most individual taxpayers. However, the most important reforms affecting retirement saving, the tax treatment of interest income and expense, and the taxation of capital gains are summarized briefly in chapter 5.

It is worth repeating here the watchwords (described further in chapter 2) that guided development of these reforms: simplicity; fairness; lower rates; economic neutrality; economic growth; and fair and orderly transition.

#### A. Individuals

The financial affairs of most American taxpayers are not very complicated -- certainly, they are not as complicated as the income tax law makes them appear. Exclusions, adjustments, itemized deductions, and tax credits create much of the complexity in the individual income tax. If not required for the fair and accurate measurement of income or taxpaying ability, these provisions violate basic notions of fairness and distort economic choices. By reducing the tax base, they make necessary the high tax rates that stifle incentives and retard economic growth.

1. Fairness for families. The personal exemptions will be increased to \$2,000, and the zero-bracket amounts will be raised to \$3,800 for a couple filing a joint return, to \$3,500 for a head of household, and to \$2,800 for a single person. This will eliminate income tax for virtually all families with incomes below the poverty level. The dollar limits on the earned income tax credit will be indexed for inflation. The tax-exempt level for the elderly will be increased slightly, even though the extra exemption for the aged will be eliminated. The special exemption for the blind will be folded into an expanded credit for the elderly, blind, and disabled.

2. Lower tax rates. The present 14 tax rates (15 for single returns) will be collapsed into 3 rates, 15, 25, and 35 percent. (See Table 4-1.) The first of these will apply only to income above the

Table 4-1

## Proposed Tax Rates for 1986

Taxable Income Covered by the Tax Rate 1/				
Tax Rate :	Single Returns	Joint Returns	Head of Household Returns	Married Filing Separately Returns
0%	Less than \$2,800	Less than \$3,800	Less than \$3,500	Less than \$1,900
15%	\$2,800 to \$19,300	\$3,800 to \$31,800	\$3,500 to \$25,000	\$1,900 to \$15,900
25%	\$19,300 to \$38,100	\$31,800 to \$63,800	\$25,000 to \$48,000	\$15,900 to \$31,900
35%	\$38,100 and over	\$63,800 and over	\$48,000 and over	\$31,900 and over
Office of the Secretary of the Treasury Office of Tax Analysis				November 25, 1984

1/ Taxable income is equal to adjusted gross income less \$2,000  
for each exemption for a taxpayer or dependent.

Note: After 1986, both personal exemptions and tax bracket boundaries will  
be indexed to reflect inflation.

tax threshold, which will be \$11,800 for a family of four. The personal exemption, zero bracket amount, and other bracket limits will be indexed, as under current law.

A couple filing a joint return will not reach the 25 and 35 percent rates until taxable income exceeds \$31,800 and \$63,800, respectively. By comparison, in 1986 under current law and expected 1985 inflation, the 25 percent rate will apply to income in excess of \$26,850, and rates of 38 to 50 percent will be levied on incomes in excess of \$49,980.

On average, the marginal tax rates that will be paid on economic income under the Treasury Department proposals are 20 percent lower than under current law. Individual tax liabilities will be reduced an average of 8.5 percent. Of course, the percentage reduction in taxes is greater at the bottom of the income scale, due to the increase in the tax threshold. Tax liabilities of families with incomes below \$10,000 will fall by an average of 32.5 percent and the reduction in taxes for families with income of \$10,000 to \$15,000 will be 16.6 percent. These changes are discussed further in section III.

3. Fair and Neutral Taxation. In order to achieve fair and neutral taxation and to allow rates to be reduced, it is necessary to define the tax base more accurately and more comprehensively than under current law. Certain fringe benefits -- most notably the cost of medical insurance in excess of \$175 per month for a family and \$70 per month for a single person and group term life insurance -- will be subject to tax. Payments that replace lost wages will also be taxed. Since several forms of wage replacement will be eligible for the expanded credit for elderly, blind, and disabled, subjecting these forms of income to tax generally will not affect families with incomes below the poverty line. Real capital gains will be taxed as ordinary income, but interest income and capital gains that only reflect inflation will not be taxed at all.

Deductions for expenditures that are presently tax-preferred will be eliminated or curtailed. The deduction for State and local taxes will be phased out, and itemized deductions will be allowed for charitable contributions only to the extent that they exceed 2 percent of adjusted gross income. The deduction for charitable contributions by nonitemizers will be repealed. Deductions will be allowed for interest expense in excess of investment income only up to the amount of mortgage interest on the principal residence of the taxpayer, plus \$5,000. The existing deductions for medical expenses and casualty and theft losses will be retained unchanged. The complicated credit for child and dependent care will be converted to a simpler deduction, available to nonitemizers as well as itemizers, in recognition that child and dependent care is an expense of earning income. Other expenses of earning income will be combined into one adjustment, or above-the-line deduction, subject to a de minimis floor of one percent of adjusted gross income. The two-earner deduction will be repealed.

Under the Treasury Department proposals it will not be possible to use gifts to children or trusts to circumvent the graduated rate structure.

4. Retirement Saving Incentives. Present law refrains from fully taxing economic income by providing tax-preferred treatment of saving for retirement. The Treasury Department proposals will retain this treatment and, indeed, will liberalize the present tax treatment of Individual Retirement Accounts (IRAs). Spouses who work in the home will be eligible to make tax-deferred contributions to an IRA on equal terms with those who are employed in the marketplace. The Treasury Department proposes that the limits on tax-deferred contributions to IRAs be raised to \$2,500 (\$5,000 for a husband and wife). This proposal will, in effect, allow the vast majority of taxpayers to defer tax on most of their financial saving.

5. Simplification. The increased personal exemptions and zero-bracket amounts and the curtailment of itemized deductions and credits will bring considerable simplification. Of the 97 million tax returns filed currently, 16 percent involve no tax liability. This figure will rise to 22 percent. Roughly 35 percent of all returns now report itemized deductions. This figure will drop by about a third under the Treasury Department proposals, relieving an additional 10 to 11 percent of all taxpayers of the need to record expenses and itemize deductions.

In order to simplify tax compliance further, the Internal Revenue Service (IRS) will examine the possibility of implementing a system under which many taxpayers would no longer be required to prepare and file tax returns. Under such a "return-free" system, the IRS would, at the election of each eligible taxpayer, compute their tax liability, based on withholding and information reports provided to the IRS currently and send the taxpayer a report on the calculation of tax liability. The taxpayer would, of course, be allowed to question the IRS calculation of tax. Institution of the "return-free" system, together with the increases in zero-bracket amount and the personal exemptions, would substantially reduce the number of returns that taxpayers need to file with the IRS each year. This, in turn, would eliminate burdensome recordkeeping and cost requirements incurred by taxpayers in preparing returns.

## **B. Taxation of Capital and Business Income**

The taxation of capital and business income in the United States is deeply flawed. It is best characterized as irrational and internally inconsistent. Effective tax rates on investment income are unpredictable, as they vary tremendously with inflation. The tax law provides subsidies to particular forms of investment that are unfair and that seriously distort choices in the use of the Nation's scarce capital. The interaction of various provisions results in opportunities for tax shelters that allow wealthy individuals to pay little tax, create the perception of a fundamentally unfair tax system, and further distort economic choices. The double taxation of dividends

discourages equity investment in the corporate sector, and needlessly high marginal tax rates create disincentives for saving, investment, invention, and innovation. Moreover, high marginal rates encourage efforts to obtain additional special tax benefits which, if successful, further erode the tax base and necessitate even higher rates in a vicious cycle. The international allocation of U.S. capital is also distorted.

The tax reforms proposed by the Treasury Department will rationalize the taxation of income from business and capital. The primary objective of reform is to subject real economic income from all sources to consistent tax treatment. Uniform taxation of all income is necessary in order to minimize interference of the tax system with the market-determined allocation of economic resources among competing uses. A comprehensive and consistent definition of the tax base is also needed to restore both the fairness of the tax system and the public perception of fairness. Finally, the tax base must be broadened in order to allow the reduction of both individual and corporate income tax rates.

1. Taxing Real Economic Income. Real economic income should be measured accurately during periods of inflation. The Treasury Department proposes that inflation adjustments be made in the calculation of depreciation allowances, capital gains, the cost of goods sold from inventories, certain charitable contributions, and interest income and expense. This reform will eliminate the need for the arbitrary ad hoc adjustments for inflation currently incorporated in the investment tax credit, the accelerated write-off of depreciable property, and the partial exclusion of long-term capital gains. Replacing the investment tax credit (ITC) and the Accelerated Cost Recovery System (ACRS) with real economic depreciation and taxing real capital gains as ordinary income will eliminate the great disparities in the taxation of various industries under current law. Inflation adjustment will prevent effective tax rates on investment income from depending on the rate of inflation in ways that vary across asset types and industries. The taxation of real economic income at lower rates, coupled with several additional reforms, will reduce the opportunities and incentives for tax shelter activities and, thus, allow investment decisions to be motivated by economic realities rather than by tax considerations.

2. Retirement Savings Incentives. The tax treatment of retirement savings, a major source of funds for capital formation in the United States, should be expanded and rationalized. The Treasury Department believes that the basic elements of the current tax structure which favor retirement savings should be retained and that the tax incentives encouraging such saving should be expanded. Accordingly, the Treasury Department proposes that the limits on contributions to individual retirement accounts (IRAs) be increased and that availability of IRAs be extended on an equal basis to spouses not employed in the marketplace. Under the Treasury Department proposals much of the financial saving of families will be accorded favorable tax treatment. According to one survey, only 39 percent of all

American families have accumulated total financial assets of more than \$5000. An even smaller percentage would save as much as \$5000 in any one year. As a result, individuals will experience much of the tax preference for saving associated with a consumed income tax, but the many problems involved in implementing such a personal tax on consumption (discussed in chapter 9) will be avoided. The Treasury Department also proposes that the tax treatment of retirement savings be rationalized by subjecting all pre-retirement distributions to uniform rules, and by simplifying the contribution limits applied to various tax-preferred plans.

3. Neutrality Toward Business Form. Corporations and partnerships should be taxed in more nearly the same way. The Treasury Department proposes that corporations be given a partial deduction for dividends paid in order to reduce the double taxation of dividends, and that certain large partnerships be taxed as corporations.

4. Industry-Specific Subsidies and Tax Shelters. Highly preferential tax treatment that benefits only a few selected industries should be eliminated. This special treatment is undesirable both because it is inequitable and because it violates the principle of economic neutrality. A consistent definition of taxable income would allow market forces, rather than the tax system, to determine the allocation of the Nation's scarce economic resources.

### C. Economic Effects

Implementation of the tax reforms proposed by the Treasury Department will cause a substantial reallocation of economic resources. The lower tax rates made possible by base-broadening and the more accurate rules for the measurement of income and calculation of tax liabilities will stimulate investment in industries that are burdened by the current unfair and distortionary tax regime. The proposed reforms will thus benefit both some established industries as well as new "high-tech" industries.

However, the primary beneficiaries of the Treasury Department's proposals will be the American public. No longer will the allocation of the Nation's scarce economic resources -- its labor, its capital, its land, and its inventive genius -- be distorted by the biases of the current tax system. Instead, under the economically neutral tax system proposed by the Treasury Department, market forces will direct resources to those activities where returns are greatest. The result will be more productive investment and thus greater output. A more effectively utilized capital stock will result in a more productive, and thus more highly paid, labor force. Output prices in currently tax-favored industries will increase, while output prices in currently tax-disadvantaged industries will fall. As a result, a more useful mix of goods will be produced, since consumer prices will adjust to reflect these changes in costs, and consumer demand will no longer be artificially distorted.

In addition, the biases under current law against emerging firms, especially those with relatively low demands for physical capital, will be eliminated. The current bias toward firms with relatively large investments in depreciable assets, especially short-lived equipment, will be eliminated under a capital recovery system that approximates economic depreciation. Economic depreciation will reduce the current bias toward established firms that can fully utilize special deductions and credits by replacing the present "front-loaded" capital recovery system of ACRS and the ITC. Moreover, the current bias toward established firms with retained earnings will be reduced by decreasing the marginal tax rate on corporate income paid out as dividends. Since retained earnings would not have as large a tax advantage over new equity, firms in need of new equity financing will find it more readily available. Since many firms in the "high technology" industries are emerging and relatively low capital intensity, the proposed reforms will foster invention and innovation by benefitting such firms. The reform proposal thus would promote faster economic growth, in addition to improving the allocation of the Nation's resources at any single point in time.

The Treasury Department proposals will affect different industries in different ways; in particular, not all industries would benefit from tax reform. That is the nature of the tax reform problem. The only way to reduce the burden of taxes on industries that pay above-average taxes under current law is to shift part of that burden to industries where taxes are now artificially reduced by special provisions. Taxpayers that would lose special tax preferences under the proposed reforms include the oil and gas industry; banks, life insurance companies, and other financial institutions; and industries in which production extends over several years.

Although it is possible to identify the industries that would lose special tax preferences, it is impossible to predict the precise economic effects of the entire package of Treasury Department proposals on all industries and individuals in the economy. Although many mathematical models of the economy exist, economic science simply is not sufficiently precise to allow accurate prediction of the effects of reforms as fundamental and pervasive as those proposed by the Treasury Department; accordingly, this Report contains no such attempt at precise quantification of economic effects.

#### **D. Transition**

Enactment of the Treasury Department proposals would undoubtedly result in a sizable reallocation of resources. Costly dislocations and unanticipated losses caused by tax reform can -- and should -- be mitigated through provisions for fair and orderly transition. This Report contains many recommendations (see Volume 2) for delayed or phased-in enactment dates. Moreover, "grandfathering" provisions designed to maintain current tax treatment for commitments made under present law would mitigate the dislocations and windfall losses associated with implementing reform. Nevertheless, transition to a more equitable and more neutral system must occur. To resist

permanently the need to tax all real economic income consistently and uniformly would be to perpetuate the high tax rates, inequities, and tax-induced distortions of resource allocation that currently plague the economy. It would also threaten the viability of our voluntary income tax system by allowing these defects to continue to undermine taxpayer morale.

## **II. Effects on Revenues**

The Treasury Department proposals are designed to be revenue neutral. That is, they raise roughly the same amount of revenue as current law, when fully phased in, and during each of the transition years, FY 1986-90. Table 4-2 shows projected tax receipts under both current law and the Treasury Department proposals, plus receipts under the proposals as a percent of current law receipts, for fiscal years 1986-90.

During FY 1986, receipts under the proposals exceed those under current law by \$0.5 billion. In FY 1987, they fall short of current receipts by \$5.8 billion. During the FY 1988-90 period, receipts under the proposal exceed those under current law by an average of \$6.0 billion, or 0.9 percent of current law receipts. These deviations from receipts under current law are small enough, compared to potential errors in estimates, that the proposals should be characterized as revenue neutral.

It would not be helpful to show actual dollar receipts beyond the transition period, given the vagaries of forecasting so far into the future. But, when fully phased in, the proposal raises about 1 to 3 percent less revenue than current law. In other words, if receipts under current law would have otherwise been \$1 trillion, they will be \$10 to \$30 billion less under the Treasury Department proposal when fully phased in. Thus, even when fully phased in, the proposals are revenue neutral.

The estimates of receipts for 1986-90 are based on the economic forecast in the 1984 Mid-session Review. The estimates reflect the assumption that the level of economic output is not affected by the tax reforms being proposed. In fact, the dramatic reductions in marginal tax rates that are being proposed can be expected to generate additional work effort, saving, investment and innovation. As a result, economic output -- and with it tax receipts -- will probably be higher than projected. Predicting how much higher is, however, inevitably a difficult task. Any estimates of the effects of increased incentives would be far outside the range of recent experience.

Table 4-2 also shows the breakdown of annual receipts between individual and corporate taxpayers. Over the period FY 1986-1990, individual receipts will be reduced by some 6 to 9 percent per year relative to current law, while corporate receipts will be 25 to 37 percent higher. Fully phased in individual receipts will be 8.5 percent lower; corporate receipts will be about 24 percent higher.

Table 4-2

45-

November 24, 1984

Note: Details may not add to totals due to rounding.

### III. Effects on Income Distribution and Incentives

The Treasury Department has designed its proposals to be basically neutral from a distributional point of view, as well as revenue neutral, once fully phased in. That is, the distribution of individual income tax burdens across income classes does not differ significantly from that under current law, except in one important respect. An explicit goal of the study is the elimination of income tax liability from families with incomes below the poverty level. To achieve the increase in the tax threshold required to meet this objective, the personal exemptions and zero-bracket amounts will be increased, thus increasing slightly the relative burdens of all taxpayers above the new tax-exempt levels of income.

One way to see the distributional neutrality of the proposed package of tax reforms and simplification is to examine the percentage distribution of tax liabilities under present law and proposed law. A comparison of lines 5 and 6 of Table 4-3 reveals that the percentage distribution of tax liabilities would not be changed significantly, except at the bottom of the income scale, where burdens would clearly be reduced.

Although the proposed tax reforms reduce total revenues from the individual income tax by 8.5 percent, the increase in the tax threshold is reflected in substantially greater reductions in taxes paid in the bottom two income classes. Liabilities of families with incomes below \$10,000 fall by 32.5 percent and those of families with incomes between \$10,000 and \$15,000 fall by 16.6 percent. Above average, but smaller reductions are also experienced in the next three income classes. In the three income classes above \$50,000 the reduction in taxes is slightly less than average, at 6.4 to 8.0 percent. (See line 9 of Table 4-3 and Figure 4-2.)

The distributional neutrality of the proposed reforms is also shown by the pattern of average tax rates paid at each income level, under present law and the proposed law. (See lines 10 and 11 of Table 4-3 and Figure 4-1.) Under current law, the average rates increase steadily from about 1-1/2 percent for those with incomes below \$10,000 to roughly 21 percent for taxpayers with income in excess of \$200,000. Under proposed law the range of average rates is from about 1 percent to just above 19 percent.

The pattern of average tax rates, that is, the percentage of total income taken by taxes at various income levels, is relevant for judging the distributional fairness of the tax system. The figures just presented show that the reforms proposed do not significantly redistribute tax burdens across income classes except insofar as tax burdens at the very bottom of the income scale are reduced dramatically; that is, the proposals are basically distributionally neutral.

Average tax rates do not indicate the extent to which taxation creates disincentives for productive economic activities. To appraise

Table 4-3

Distribution of Adjusted Gross Income, Taxable Income,  
Income Tax, And Tax Rates Under Present Law And Under  
The Tax Reform Proposal 1/

	Family Economic Income Class (in thousands) 2/								
	\$0 - 10	10 - 15	15 - 20	20 - 30	30 - 50	50 - 100	100 - 200	200 & over	All Income Classes
<b>I. Percentage Distribution of:</b>									
Adjusted Gross Income Under									
1. 1986 present law .....	1.7	4.1	5.7	14.3	28.4	31.7	8.2	6.0	100.0
2. Tax reform proposal .....	1.8	4.1	5.7	14.3	28.2	31.4	8.1	6.5	100.0
Taxable Income Under									
3. 1986 present law .....	1.5	3.9	5.6	14.6	28.9	31.6	8.1	6.0	100.0
4. Tax reform proposal .....	1.2	3.3	5.0	13.5	28.1	32.6	8.9	7.5	100.0
Tax Liability Under									
5. 1986 present law .....	.5	1.8	3.3	10.3	24.3	32.8	12.3	14.9	100.0
6. Tax reform proposal .....	.3	1.6	3.1	10.2	24.1	33.1	12.6	15.0	100.0
<b>II. Percentage Change in</b>									
7. Adjusted gross income .....	4.5	3.3	3.5	3.3	2.1	2.0	1.4	10.1	2.8
8. Taxable income .....	-16.3	-13.7	-10.5	-6.4	-1.8	4.4	11.2	24.9	1.0
9. Tax liability .....	-32.5	-16.6	-12.1	-9.1	-9.3	-7.4	-6.4	-8.0	-8.5
<b>III. Average Tax Rate Under</b>									
10. 1986 present law .....	1.4	3.2	4.6	6.2	7.8	9.4	13.2	20.9	8.7
11. Tax reform proposal .....	.9	2.7	4.0	5.7	7.0	8.7	12.3	19.3	8.0
<b>IV. Average Marginal Tax Rate</b>									
12. 1986 present law .....	4.2	9.4	12.4	16.0	20.9	27.6	37.5	46.1	23.6
13. Tax reform proposal .....	3.7	8.5	11.0	14.0	16.5	22.1	30.5	33.2	18.9
14. Percentage change .....	-11.9	-9.6	-11.3	-12.5	-21.1	-19.9	-18.7	-28.0	-19.9

Office of the Secretary of the Treasury  
Office of Tax Analysis

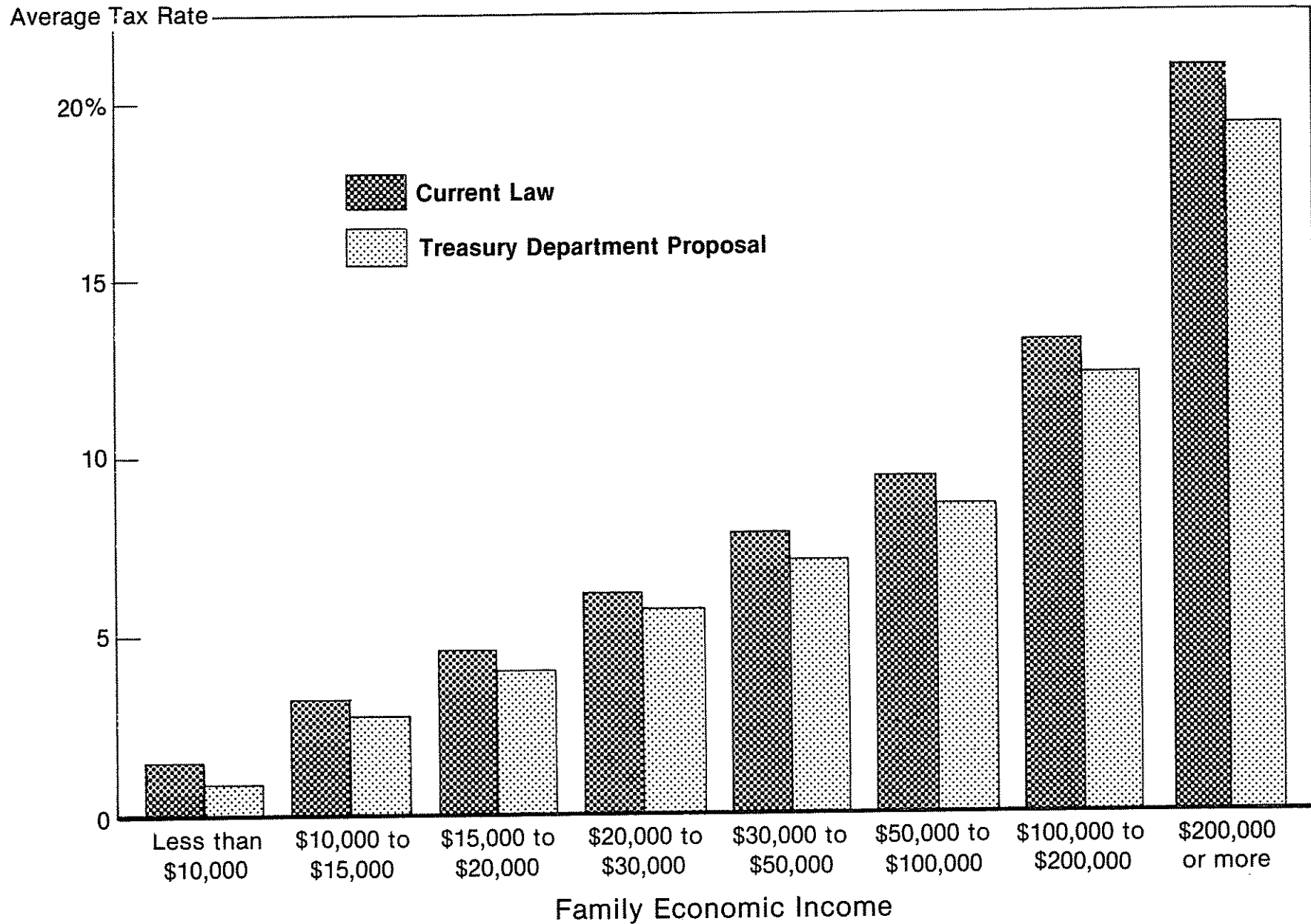
November 24, 1984

1/ See Appendix 4-B for a listing of the tax reform provisions included in the analysis. Distributions are based on 1983 levels of income.

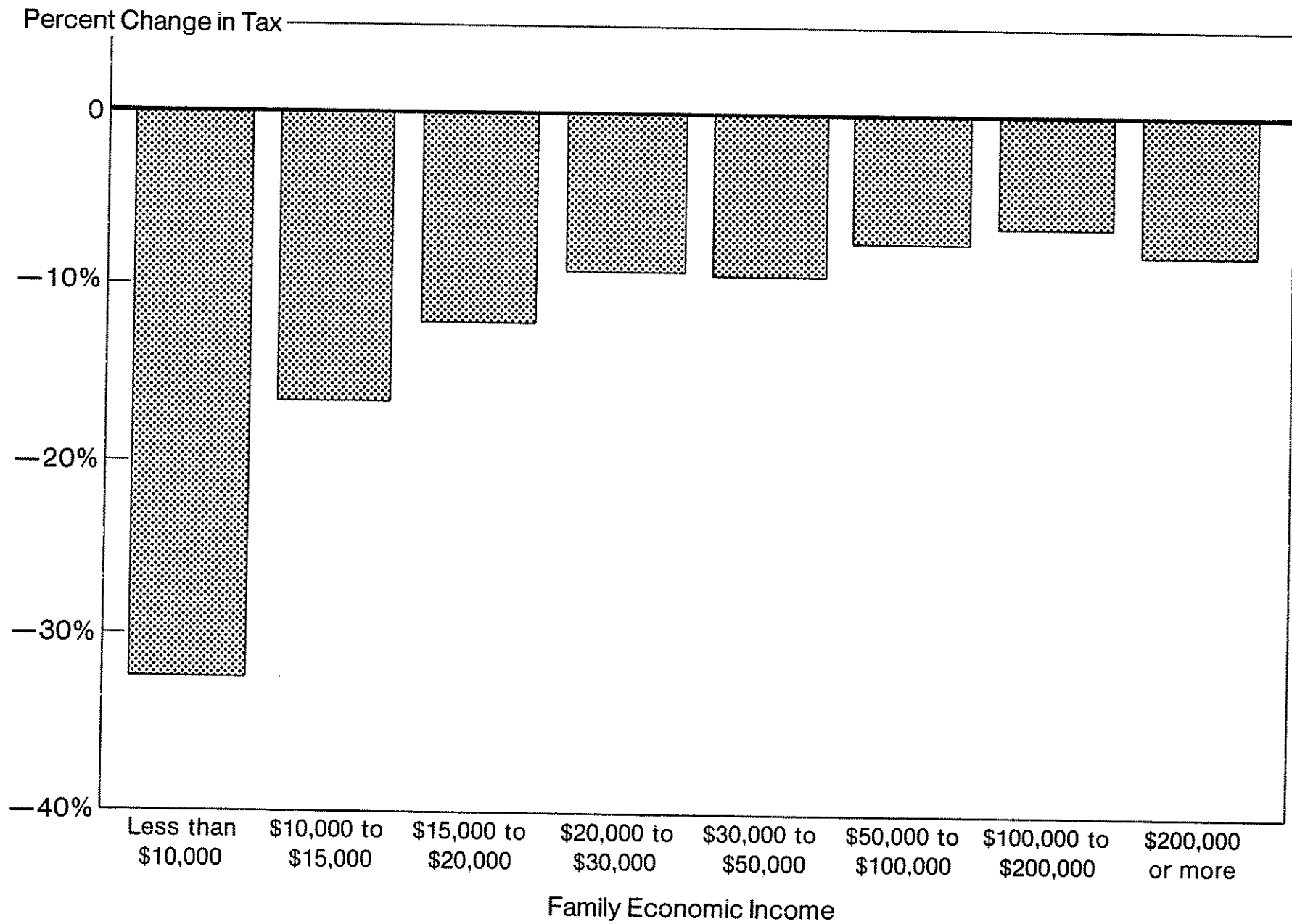
2/ Restricted to families with nonnegative income. See Appendix 4-A for description of economic income.

Figure 4-1

## AVERAGE RATES OF TAX ON FAMILY ECONOMIC INCOME UNDER CURRENT LAW AND THE PROPOSAL



# PERCENT CHANGE IN TAX UNDER THE PROPOSAL BY FAMILY ECONOMIC INCOME



incentive effects it is necessary to know marginal tax rates, that is, the percentage of an additional dollar of income that will be taken by taxes.

Lines 12 to 14 of Table 4-3 and Figure 4-3 present data on marginal tax rates paid, on the average, at various income levels. In the aggregate the proposed reforms reduce marginal tax rates by 19.9 percent, from 23.6 percent to 18.9 percent. The fact that marginal tax rates can be cut this much while average tax rates fall by only 8.5 percent shows clearly the advantage of defining taxable income comprehensively. By levying lower marginal tax rates on a broader tax base, it is possible to avoid the disincentive effects of higher rates.

Marginal tax rates paid by families in the three income classes between \$30,000 and \$200,000 fall, on average, by about 20 percent. The marginal tax rates paid, on the average, by families with income below \$30,000 fall by 10 to 13 percent. Even though marginal income tax rates do not fall as much at this income level as at others, they are low, on average, ranging from only 4 to 14 percent under the proposed law.

In the very highest income bracket, that above \$200,000, the marginal tax rate falls by 28 percent, from 46 percent to 33 percent. It bears repeating that this relatively greater cut in marginal rates in the top income classes does not imply that high-income taxpayers will experience a relatively greater tax cut than taxpayers with lower incomes. As line 9 of Table 4-3 indicates, all income groups above the \$50,000 income level experience smaller than average tax reductions. Rather, marginal rates fall furthest at the top of the income distribution because that is where the tax base is increased by the largest fraction. The proposed tax reforms increase adjusted gross income (AGI) for all families by only 2.8 percent. (See line 7 of Table 4-3.) But for families with income in excess of \$200,000, AGI increases by 10.1 percent, as a result of eliminating many provisions that allow income to be sheltered from tax.

The total of taxable income for all families is virtually unchanged under the Treasury Department proposals. (See line 8 of Table 4-3.) But for those with incomes below \$15,000, taxable income falls dramatically -- by 14 to 16 percent, due primarily to the increase in the personal exemptions. Smaller reductions in taxable income extend through the \$30,000 to \$50,000 income class. Above that point, taxable income increases, with taxable income of those with incomes of more than \$200,000 rising by 24.9 percent. (See Figure 4-4.)

The dramatic reduction in marginal tax rates that base-broadening makes possible at the top of the income scale emphasizes the importance of taxing all income in a consistent manner. Simply by defining the tax base comprehensively, it is possible to achieve a percentage reduction of marginal tax rates paid by high-income individuals that is larger than that provided in the Economic Recovery

Figure 4-3

## MARGINAL RATES OF TAX UNDER CURRENT LAW AND THE PROPOSAL

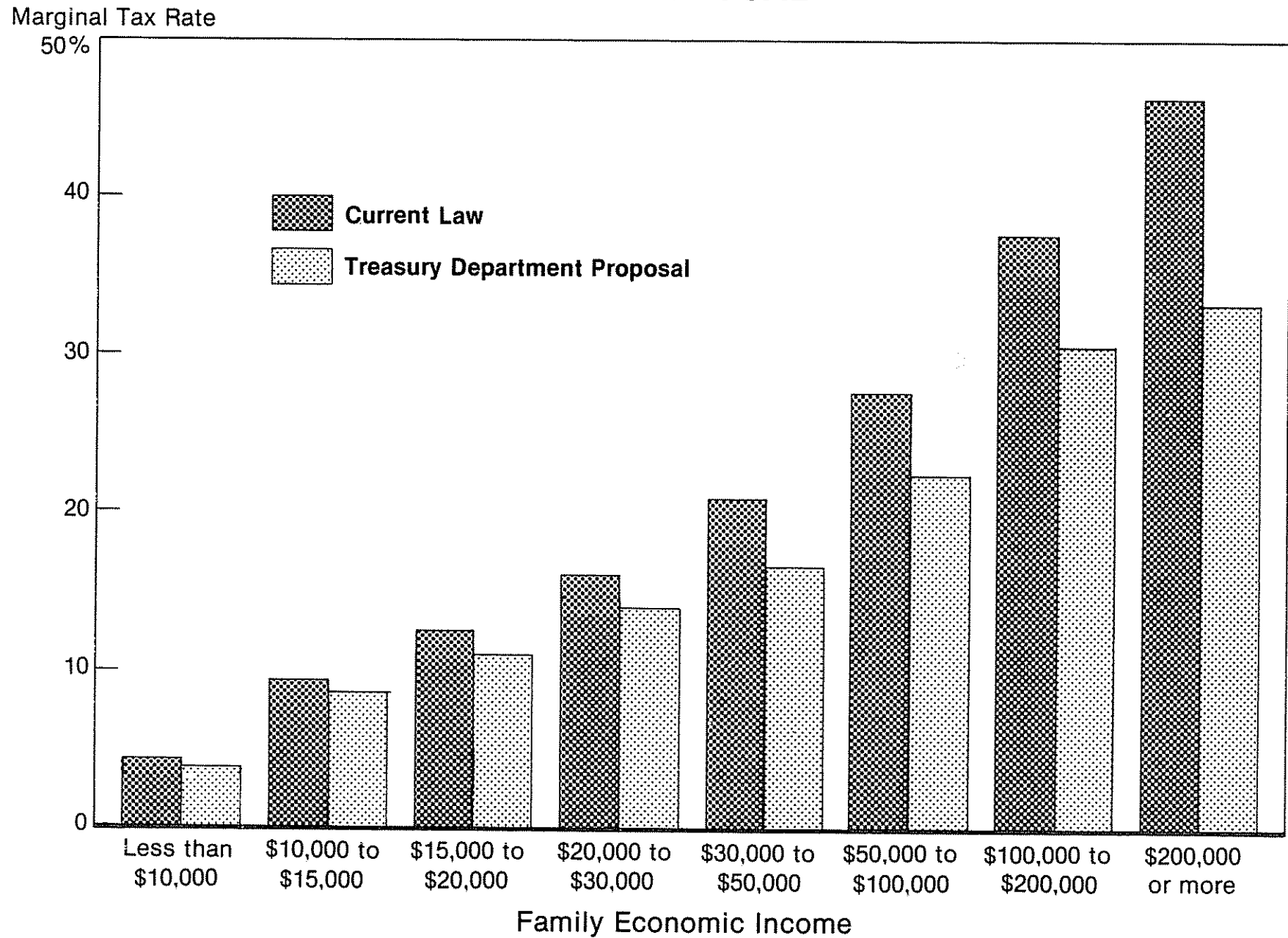
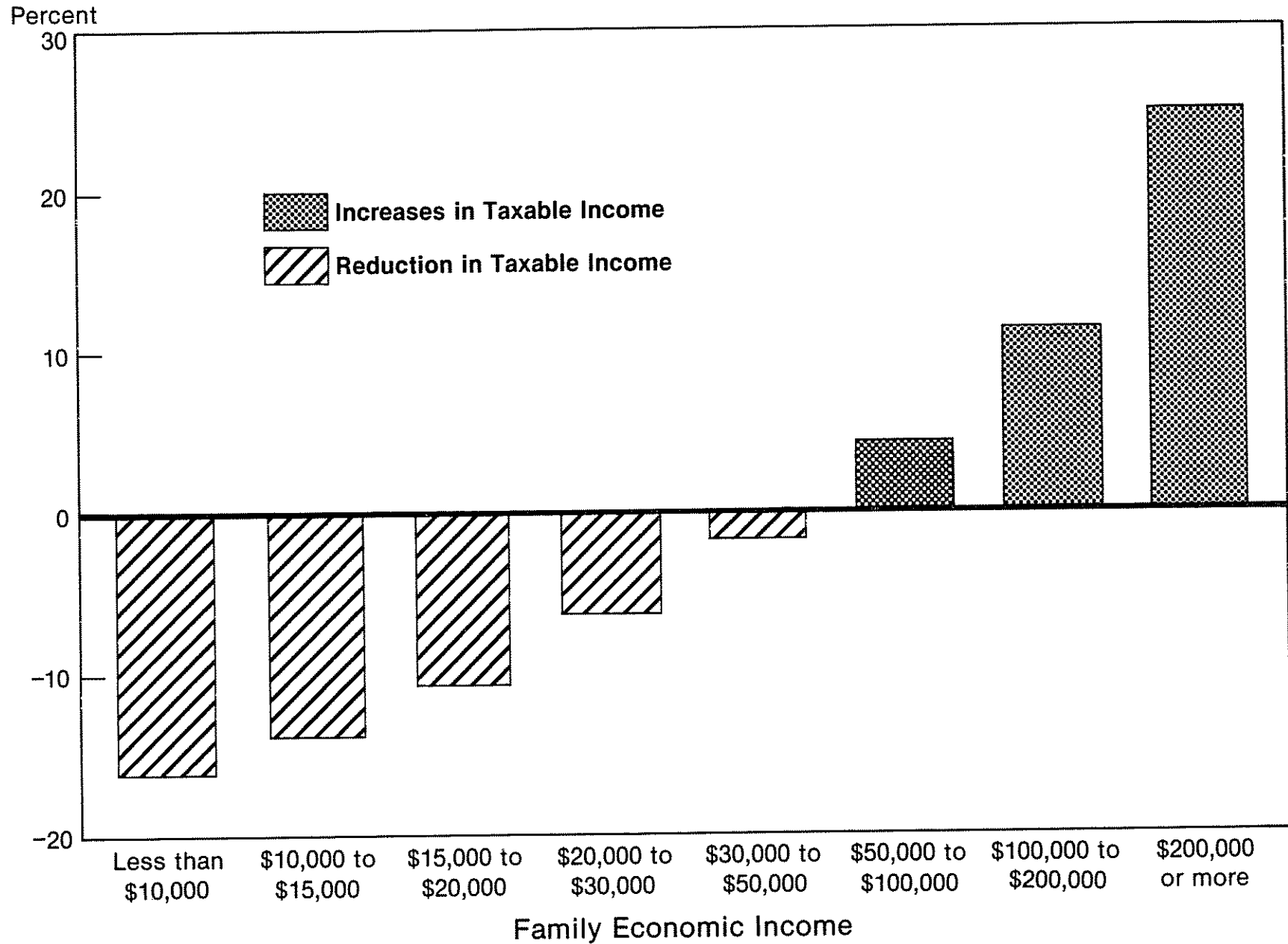


Figure 4-4

## PERCENTAGE CHANGE IN TAXABLE INCOME RESULTING FROM THE TREASURY PROPOSAL



Tax Act of 1981, and to do so while cutting taxes for them by less than they are cut for lower income classes. A reduction of marginal tax rates of this magnitude will open wide the doors of opportunity to those who are willing to work, to save and invest, and to innovate.

The advantage of base-broadening can also be seen from Table 4-4 and from Figure 4-5. Of the 91.4 million families in the country, fewer than 20 million, or about 22 percent, will experience any tax increase as a result of the Treasury Department proposals. By comparison, 56 percent will have their taxes reduced. At the lower income levels the fraction of families with tax increases is even smaller, ranging from less than 5 percent in the zero to \$10,000 income class to about 20 percent in the \$15-20,000 income class.

In every income class far more families will benefit from the Treasury Department's proposals than will lose. Moreover, there are far more families whose average tax rate will fall by a given amount (for example, less than one percentage point or more than two percentage points) than there are families whose average rates will rise by that amount. (See Table 4-4.)

Table 4-4

Distribution of Families by Change in Tax as a Percent of Income  
Comparing The Tax Reform Proposal With 1986 Present Law 1/

	Family Economic Income Class (in thousands) 2/								
	\$0 - 10	10 - 15	15 - 20	20 - 30	30 - 50	50 - 100	100 - 200	200 & over	All Income Classes
<b>I. Number of families with:</b>									
Tax INCREASE as percent of income:									
More than 2 percent.....	303	625	691	1,138	1,013	904	286	80	5,040
1 to 2 percent.....	123	368	457	1,004	1,337	870	143	28	4,330
Less than 1 percent 3/.....	224	709	980	2,160	3,667	2,458	258	26	10,482
Tax DECREASE as percent of income:									
More than 2 percent.....	1,281	1,591	1,380	2,758	4,096	2,712	514	218	14,550
1 to 2 percent.....	905	1,505	2,482	4,162	4,453	2,716	301	41	16,565
Less than 1 percent 3/.....	1,096	3,136	2,597	4,379	5,082	3,780	347	40	20,457
No change in tax.....	9,779	3,715	2,115	2,031	1,638	617	44	8	19,947
Total, all families.....	13,712	11,649	10,702	17,633	21,286	14,057	1,894	441	91,374
<b>II. Percent of Families with:</b>									
Tax INCREASE as percent of income:									
More than 2 percent.....	2.21	5.36	6.45	6.45	4.76	6.43	15.10	18.02	5.52
1 to 2 percent.....	.90	3.16	4.27	5.69	6.28	6.19	7.54	6.43	4.74
Less than 1 percent 3/.....	1.64	6.09	9.16	12.25	17.23	17.48	13.63	5.94	11.47
Total with tax increase.....	4.75	14.61	19.88	24.39	28.27	30.10	36.27	30.39	21.73
Tax DECREASE as percent of income:									
More than 2 percent.....	9.34	13.66	12.89	15.64	19.24	19.30	27.12	49.41	15.92
1 to 2 percent.....	6.60	12.92	23.20	23.61	20.92	19.32	15.91	9.40	18.13
Less than 1 percent 3/.....	7.99	26.92	24.27	24.84	23.87	26.89	18.35	9.01	22.39
Total with tax decrease.....	23.93	53.50	60.36	64.09	64.03	65.51	61.38	67.82	56.44
No change in tax.....	71.32	31.89	19.76	11.52	7.70	4.39	2.35	1.79	21.83
Total, all families.....	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

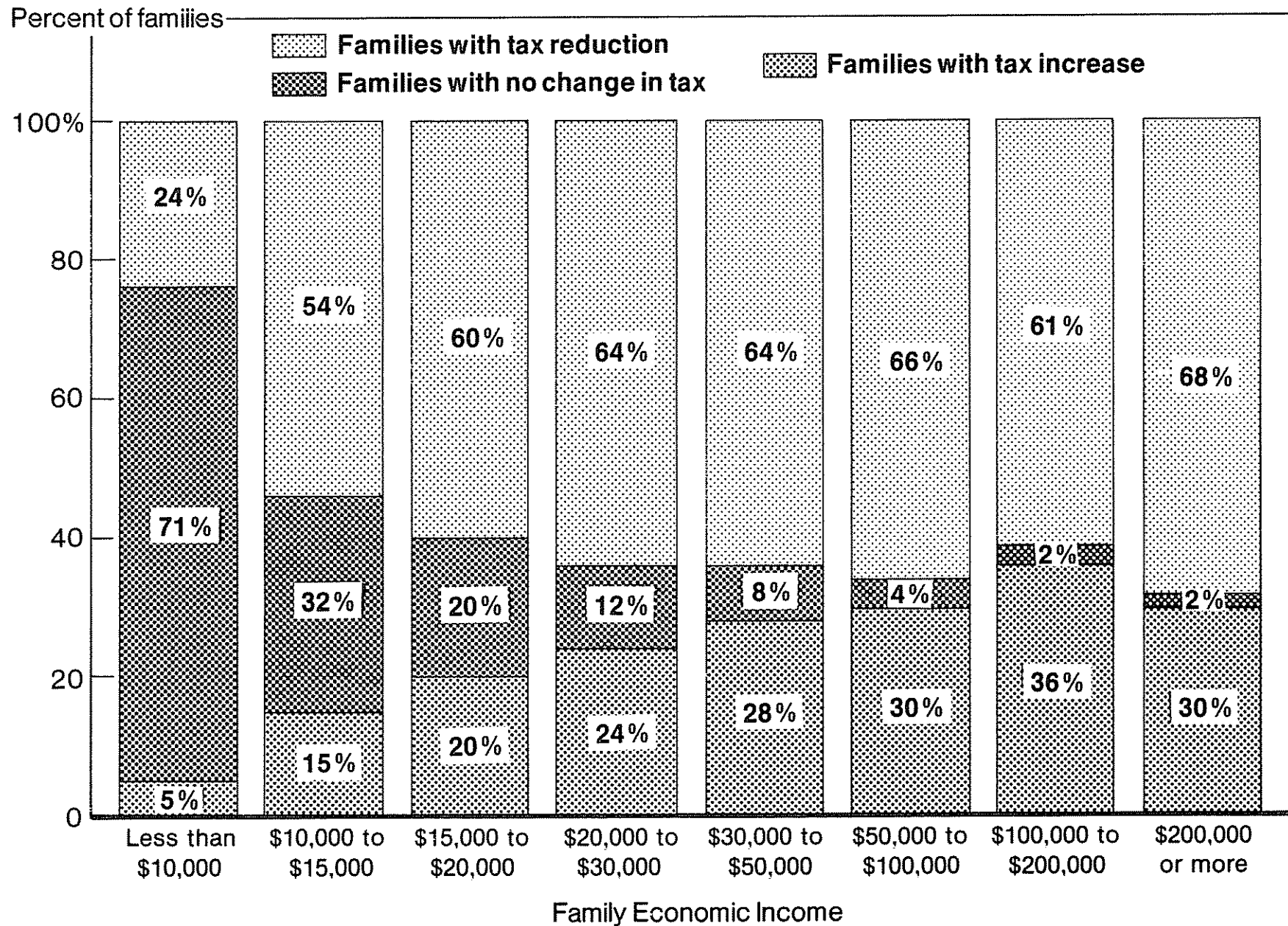
Office of the Secretary of the Treasury  
Office of Tax Analysis

November 26, 1984

- 1/ See Appendix 4-B for a listing of the tax reform provisions included in the analysis. Distributions are based on 1983 levels of income.
- 2/ Restricted to families with nonnegative income. See Appendix 4-A for description of economic income.
- 3/ Families with tax changes of less than 0.05 percent of their income were considered to have only a negligible tax change and were therefore excluded from the tax-change groupings.

Figure 4-5

# **FAMILIES WITH TAX CHANGE AS A PERCENT OF ALL FAMILIES BY FAMILY ECONOMIC INCOME**



## Appendix 4-A

### Explanation of Concept of Economic Income Used in Distributional Tables

The tables in this Report showing the distribution of current and proposed tax liabilities by family income class represent an important improvement over the kinds of comparisons the Treasury Department has been able to display in the past. They differ from the usual tables in two ways: (1) taxes and the effects of changes in tax policy are distributed over all families in the population, rather than over tax-filing units; and (2) the definition of income is a broad measure of economic income, rather than adjusted gross income.

#### Families

For many people, the tax unit and the family are the same. A family can, however, consist of several tax filing units if dependents have incomes of their own. For instance, if the children in a family have jobs or have investment funds in their names, they may have to file returns to pay taxes or to receive a refund of taxes that were withheld. For judging the fairness of the distributional burden of the tax system, the incomes and the taxes of those dependents should be included with the incomes and taxes of the taxpayers (usually parents) who support them.

Another difference between the tax return unit and the family is that many families and individuals have too little income for them to be required to file a tax return under current law. These "nonfilers" should be recognized in surveying the tax system's impact on people at different income levels. Tables based on tax returns cannot show how many people at a given income class are not even in the tax system, whereas the tables in this Report do reflect the families and individuals who do not file tax returns.

#### Income Definition

The definition of income used in this Report for classifying families and for comparing tax burdens differs from adjusted gross income and other tax system concepts of income in a number of ways. (The income classifier does not serve as the basis for actual taxation.) Economic income is a comprehensive measure of income that is intended to approximate as closely as possible the standard definition of income, consumption plus change in net worth. It includes forms of income that are not subject to tax, such as interest from tax-exempt state and local bonds and government transfer payments. It also measures more accurately certain other forms of income that are subject to tax, such as real interest income. This broader measure of income, therefore, provides a better yardstick for comparing families -- that is, for determining their abilities to pay taxes and comparing tax burdens by income class.

"Economic income" starts from adjusted gross income as reported on tax returns and adds in unreported or underreported income. It adds back certain "adjustments to income," principally IRA and Keogh contributions and the second earner deduction. Since economic income aims to measure income in the current year, it adds back net operating losses carried over from previous years. It includes cash and near-cash transfers that are not subject to tax, principally social security benefits, welfare payments, unemployment and workers' compensation, veterans' compensation, and food stamps. It adds in the untaxed portion of compensation such as employer contributions for pensions and health and life insurance and other fringe benefits. So that pension income not be double counted, it excludes pension income as received but includes the accrual of earnings on pension and life insurance plans, and on IRA and Keogh accounts. It includes tax-exempt interest. Since home owners receive implicit income from their houses, economic income includes an estimate of the real imputed net rent on owner-occupied housing.

"Economic income" reflects the view that corporations are not separate from their stockholders, but that the income of corporations is income of its stockholders; therefore, economic income allocates pre-tax corporate profits both to individuals who own stock directly and to those who own stock indirectly, for example, through shares of pension or life insurance funds. Economic income attempts to measure capital income correctly: by indexing interest receipts and expenses, by indexing capital gains and losses, by replacing tax depreciation with real economic depreciation, and by including the tax-preference component of intangible drilling costs and percentage depletion allowances.

The derivation of economic income from adjusted gross income is described in greater detail in Table 4A-1. Figure 4A-1 compares the distribution of tax returns classified by AGI with the distribution of families classified by economic income. The most striking difference is that twice as large a percentage of tax returns fall in the smallest class -- below \$10,000 -- than do families. Conversely, a much higher percentage of the families appear in the higher income classes of economic income. The chart shows clearly how poorly the distribution of tax returns by AGI approximates the distribution of families by economic income, which is a more appropriate way of viewing the population for most analytical purposes.

Table 4A-1

Economic Income Equals

Adjusted gross income:

reported on tax returns  
unreported or underreported

plus net operating losses carried over from previous years

plus adjustments to income:

IRA and Keogh contributions  
two-earner deduction  
other adjustments

plus untaxed employer contributions for:

pensions  
health and life insurance  
profit sharing  
other benefits

plus certain fringe benefits

plus certain military benefits

plus untaxed cash benefits for:

unemployment compensation  
workers' compensation  
AFDC  
SSI  
veterans' compensation  
social security  
railroad retirement

plus food stamps benefits

plus non-corporate earnings on pension and life insurance plans

less taxable pension income

plus earnings on IRA and Keogh plans

plus tax-exempt interest

plus real net imputed rent on owner-occupied homes

less realized corporate income

plus accrued pre-tax real corporate income

plus adjustment for indexing of non-corporate capital gains and losses

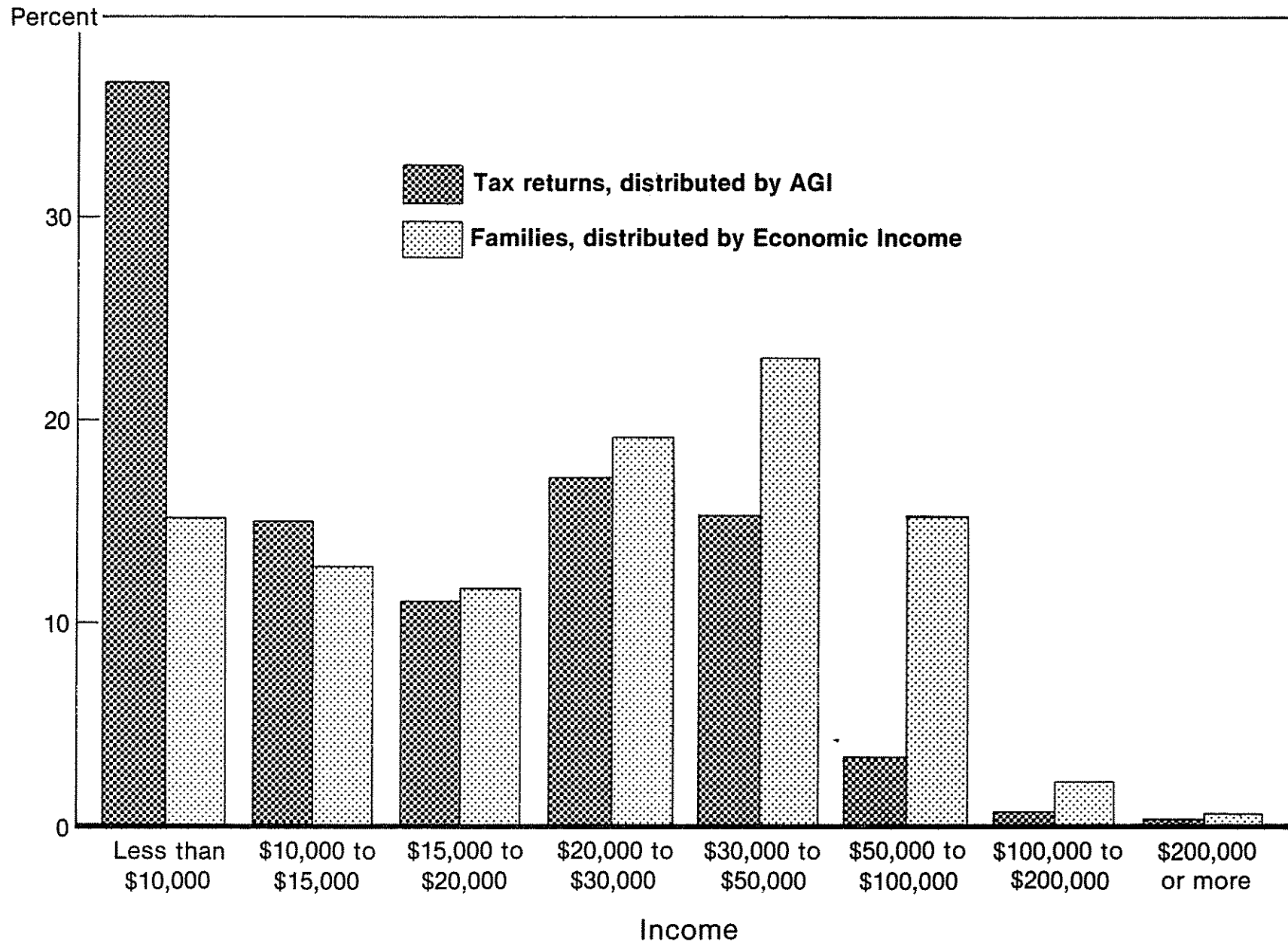
plus adjustment for indexing of interest income and expense

plus replacement of tax depreciation with economic depreciation

plus tax preference for intangible drilling costs, and percentage depletion

Figure 4A-1

## DISTRIBUTION OF TAX RETURNS BY ADJUSTED GROSS INCOME CLASS AND FAMILIES BY ECONOMIC INCOME CLASS



Appendix 4-B

Provisions Included in the Distributional Analysis in Tables 4-3 and 4-4

Income Tax Reform and Simplification for Individuals

Rate reduction

rate schedules

Fairness for families

increase in the Zero Bracket Amount (see Table 4 for details)

increase the taxpayer and dependent exemption amounts (see Table 4 for details)

repeal the two-earner deduction

index the earned income credit

convert the child-care credit to an above-the-line deduction

replace the elderly and blind exemptions with an expanded elderly credit

Fair and neutral taxation

partial taxation of employer contributions to health insurance plans

repeal the exclusion for group-term life insurance

and other employer-provided life insurance

repeal special treatment of cafeteria plans

repeal tax-exempt threshold for unemployment compensation

repeal exemption for workers' compensation

Preferred uses of income

repeal deduction for state and local taxes

limit charitable contribution deduction (2% income floor)

repeal 30 & 50 percent limitation on charitable contributions

Tax abuses

restrict entertainment expense deductions and

limit deduction for business meals

require allocation of travel expenses

eliminate certain shifting of income to trust income

Further simplifications

repeal individual minimum tax

group miscellaneous deductions with employee business expenses

and impose a 1 percent of income floor

repeal political contributions credit

disallow income averaging for full-time students

Basic Taxation of Capital and Business Income

Taxing real economic income

index capital gains and tax as regular income

index depreciation for inflation and adjust depreciation schedules

repeal the investment tax credit

index interest receipts and payments

Retirement saving

increase IRA limits

repeal the 3-year rule for retirement distributions

repeal the combined plan limit for non top-heavy plans

Neutrality towards the form of business organization

repeal the dividend exclusion

Industry specific subsidies, tax shelters, and other tax issues

repeal percentage depletion

repeal expensing of intangible drilling costs

repeal exclusion of life insurance build-up

limit interest deduction